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Foreign Activity

An Analysis of Foreign Participation in U.S. Securities Markets
Produced by the SIA Research Department

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Foreign Activity in U.S. Securities

"Highlights"

1. For the first time since the third quarter of 1978, foreign investors were quarterly net sellers of U.S. equities in the second quarter of 1984. Swinging from net purchasers of $555 million in the first quarter of 1984, foreign investors made net sales of $473 million of equities in the second quarter. Thus, foreign investment in U.S. equities amounted to only $82 million at the 1984 mid-year mark compared to $3.9 billion at the same time last year.

2. Foreign gross activity in U.S. equities declined 18% in the second quarter of 1984 to $28.7 billion from $35.0 billion in the first quarter. For the first six months of 1984, foreign gross transactions in equities were down 9% from the comparable 1983 figure of $70.3 billion.

3. Despite the falloff in equity investment, foreign investors did not turn to increased investment in U.S. corporate bonds. Foreign net purchases of corporate bonds were scaled back 86% in the second quarter to $67 million from $481 million in the first quarter. Foreign investors may have been waiting for the outcome of the proposed repeal of the 30% foreign withholding tax before committing to the attractive returns available on U.S. fixed income instruments.

4. In the second quarter, foreign net purchases of U.S. Treasuries jumped to $3.1 billion from $802 million in the first quarter. However, in contrast to past quarterly investment patterns, a substantial portion of net purchases, $1.3 billion, stemmed from international organizations. European investors purchased $1.5 billion, while Asian investors made net divestitures of $279 million of Treasuries.

5. The general disinterest of U.S. investors in foreign equity investment continued into the second quarter albeit at a greatly reduced pace. U.S. investors made net sales of $6 million of foreign stocks in the second quarter, compared with net sales of $354 million in the first quarter.

Introduction

A host of factors influence the foreign investor's decision to invest in U.S. equities. Predominant among these are the relative strength or weakness of the U.S. dollar and stock market and the comparative economic outlook. Despite a mixed performance by both the dollar and stock market in the first quarter of 1984, foreign investors made net purchases of $555 million. However, a robust economic picture exacerbated concerns over rising interest rates in the second quarter, further surpressing the stock market and overshadowing an exceptionally strong dollar. Thus, for the first time since 1978, quarterly foreign activity in U.S. equities resulted in net sales. Foreign investors made net sales of $473 million, bringing total foreign investment in U.S. equities to only $82 million in the first half of 1984.

The weakness of the dollar in the first quarter stimulated dollar pundits to predict its ultimate decline. The validity of these predictions was dismissed early in the second quarter, as the dollar resumed its advance against all major currencies. Nevertheless, with real GNP expanding at a healthy 7.6% annual rate, the potential for a buildup of inflationary pressures continued to worry financial markets. Also contributing to the financial markets' "jitters" was continued concern over financing the Federal deficit. Indeed, interest rates took a notable upturn during the quarter, with rates on corporate bonds rising 125 basis points to 14.5% by the end of June. In addition, the prime rate was boosted to 13.0% from 11.5% over the period. With rising interest rates undermining stock market progress, investors worldwide adopted a wait-and-see approach to equity investment.

The uneven performance of the dollar in the first quarter of 1984 was more than offset by gains against all major currencies in the second. The sharpest depreciation vis-a-vis the dollar, 11%, was suffered by the French franc. In addition, the dollar appreciated over 7% against both the Swiss franc and German mark. The pound and yen gave up about 6%, while the Canadian dollar depreciated 3%.

In contrast to the dollar, the U.S. stock market continued to slide in the second quarter. The NYSE and S&P 500 indices registered a 4% drop, cumulating in a 7% drop for each index from year-end 1983. The Dow Jones Industrial Average declined by almost 10% in the first half of the year. While the U.S. market has been on a downtrend in 1984, stock markets in some other countries registered impressive gains in the first quarter. However, Geneva's Capital International Perspective reports that seventeen out of nineteen of the world's major stock markets suffered setbacks in the second quarter.

Foreign Activity in U.S. Equities

Gross Activity

Foreign activity in U.S. equities declined 18% in the second quarter to $28.7 billion from $35.0 billion in the first quarter. Thus, total gross transactions for the first half of 1984 ($63.7 billion) are down 9% from the $70.3 billion generated by the 1983 mid-year mark. The second-quarter 1984 figure reflected a cutback in gross transactions by all major countries. Both European and Asian investors reduced activity by a significant 22%, while transactions stemming from Canada and Latin America decreased by over 6%.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$20,403	$311	$15,952	$(390)
Belgium-Luxembourg	752	20	568	0
France	2,071	(173)	1,362	134
Germany	1,995	361	1,119	(81)
Netherlands	1,148	32	1,009	(137)
Switzerland	6,490	186	4,906	(250)
United Kingdom	7,440	(130)	6,458	(138)
Canada	4,342	708	4,034	170
Latin America & Caribbean	4,693	181	4,432	144
Bermuda	1,666	144	1,376	4
Netherlands Antilles	1,873	23	2,039	153
Asia	4,998	(582)	3,900	(430)
Hong Kong	876	(80)	551	(69)
Japan	571	39	433	1
"Other Asia"*	3,254	(604)	2,439	(441)
Total All Countries	$34,983	$555	$28,693	$(473)

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

Net Purchases

For the first time since 1978, foreign investors were quarterly net sellers of U.S. equities. In contrast to net purchases of $555 million in the first quarter of 1984, foreigners were net sellers of $473 million of equities in the second quarter. Net sales of $390 million by European investors were primarily responsible for the turnabout. In addition, Canadian net purchases plunged by 75% to $170 million from an unusually large $708 million in the first quarter. Latin American and Caribbean investors moderated interest in U.S. equities by 20%. On the other hand, the long-standing net divestiture pattern of the Asian countries continued in the second quarter, with net sales of $430 million.

European Investors

European investors were net sellers of $390 million of U.S. equities in the second quarter. Disenchantment with the U.S. equity market was widespread. With the exception of investors located in France and the Belgium-Luxembourg countries, investors from most major countries were net sellers. Of the net sellers, Swiss investors made the most dramatic quarterly turnaround, reversing their investment posture from net purchasers of $186 million of equities to net sellers of $250 million. On the other hand, French investors became net purchasers of $134 million in the second quarter, after making net sales of $173 million in the first.

There was earlier evidence that Swiss investors were losing their enthusiasm for U.S. equities in the first quarter of 1984, as net purchases of $186 million were based solely on one month's activity. In the second quarter, Swiss caution over U.S. equities cumulated in net sales of $250 million. Similar to the U.S. stock market, the Swiss market has been lackluster in 1984. With uncertainty over the path of interest rates and a rising dollar in the second quarter, Swiss investors may have shifted their focus to some of the innovative new instruments in their capital markets. For example, dual currency bonds, which are denominated in Swiss francs but repayable in U.S. dollars and pay a higher yield than conventional bonds, are reportedly enjoying popularity with Swiss retail investors.1/

The exceptional appetite of German investors for U.S. dollar-denominated assets, both equity and fixed income, diminished in the second quarter. German investors were net sellers of $81 million of equities in contrast to $361 million

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1/ "Another record year", Financial Times, 3/19/84.

of net purchases in the first quarter. Despite the dampening effects of the metalworkers' strike and a still high unemployment rate, the outlook for the German economy is optimistic. Consumer demand initially fueled the recovery, and strong export demand is contributing to its current momentum. Given the uncertainties about the U.S. economic outlook in the second quarter, German investors may have turned to domestic investment opportunities.

Compared with prior years, U.K. investors cooled considerably to investment in U.S. equities in 1983, making net sales of $61 million in the fourth quarter of the year. The stepped-up net selling of the first quarter of 1984 continued in the second quarter, with net sales of $138 million. London money managers are reportedly taking a cautious approach to equity investment worldwide, citing the concern over the state of the U.S. economy. Among the reasons given for increased liquidity preferences are: feelings that actions to pare the Federal deficit will not be taken until after the elections, "nervousness" over the ballooning U.S. current account, and the condition of the world banking system.2/

The only major European country with net purchases of U.S. equities in the second quarter was France. In contrast to the persistent net selling pattern since the third quarter of 1983, French investors made net purchases of $134 million. However, this was based on activity in the first two months of the second quarter as French investors resumed a net divestiture posture in June.

Canadian Investors

Canadian net purchases of U.S. equities fell 76% in the second quarter to $170 million from a significant $708 million in the first quarter. Nevertheless, with net purchases of $878 million during the first half of 1984, Canadian investors were the largest foreign purchasers of U.S. equities. While Canadian interest rates were moderately higher than U.S. rates at the beginning of the year, this differential widened sharply in the first two months of the second quarter. Canadian investors may have turned their attention to domestic fixed income investments.

2/ "Carry an Umbrella", Barron's, 8/6/84.

Asian Investors

The level of net selling of U.S. equities by Asian investors dropped 26% to $430 million in the second quarter from $582 million. Although net sales of the oil-exporting countries were reduced to $441 million from $604 million in the first quarter, total sales for the first half of 1984 represented an acceleration of the net divestiture trend of 1983. A sluggish oil market, a rapidly growing infrastructure and the Iran-Iraq war have increased the liquidity needs of the oil-exporting countries. Japanese investors have shown little interest in U.S. equity investments in 1984, with $40 million purchased through the first half of the year. However, part of the record long-term capital outflow from Japan has been invested in high-yielding U.S. Treasuries.

Foreign Activity in U.S. Corporate Bonds

Despite a falloff in U.S. equity investment, foreign investors did not turn to increased investment in U.S. corporate bonds. Foreign net purchases of corporate bonds were scaled back 86% in the second quarter to $67 million from $481 million in the first quarter. While net purchases by European investors escalated by 5% to $291 million, the investment pattern among countries was inconsistent. Activity from the Asian countries resulted in net sales of $293 million, based

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$2,508	$ 276	$1,981	$291
Belgium-Luxembourg	163	(93)	126	(48)
Germany	588	20	666	292
Switzerland	454	(26)	286	14
United Kingdom	977	301	682	(8)
Asia	1,109	171	1,375	(293)
Japan	457	153	275	131
"Other Asia"	459	(27)	919	(439)
Total	$4,155	$481	$4,117	$67

Source: U.S. Treasury

mainly on net sales of $439 million by the oil-exporting countries. Thus, transactions by the major foreign investors in U.S. corporate bonds resulted in a wash, with the other foreign regions generating net purchases of $67 million. Foreign investors may have been awaiting the outcome of the proposed repeal of the 30% foreign withholding tax before committing to the attractive returns available on U.S. fixed income instruments.

Yields on U.S. corporate bonds climbed rapidly in the second quarter, increasing 125 basis points compared with 62 basis points in the first quarter.3/ U.K. corporate bond rates rose by 140 basis points, precipitating a dramatic shift on the part of U.K. investors away from U.S. corporate bonds. These investors sold $8 million of U.S. corporate bonds in the second quarter, compared to net purchases of $301 million in the first. German investors, on the other hand, stepped up net purchases to $292 million from $20 million in the first quarter.

Foreign Activity in U.S. Treasuries

In the second quarter, foreign net purchases of U.S. Treasuries jumped to $3.1 billion from $802 million in the first quarter. However, in contrast to past quarterly investment patterns, a substantial portion of net purchases, $1.3 billion, stemmed from international organizations (not shown in Table III). European investors moderated net purchases to $1.5 billion in the second quarter, while large scale net purchases by Japanese investors offset the continued divestiture of the oil-exporting countries. Estimated holdings of Treasuries by foreigners stood at $95.0 billion at the end of June.

U.S. interest rates were on an uptrend generally not matched by interest rates available elsewhere during the second quarter. Yields on short-term government instruments increased some 20 basis points, while long-term issues spurted by 116 basis points. The yield differential between U.S. and U.K. corporate bonds narrowed over the second quarter, while the differential between Treasuries increased by over 30 basis points in favor of U.S. issues. Thus, U.K. investors turned their attention from the U.S. corporate bond market to the U.S. Treasury market. U.K. investors swung from net sellers of $97 million of Treasuries in the first quarter to net purchasers of $785 million in the second. On the other hand, German investors who had been avid purchasers of Treasuries in 1983 and the first quarter of 1984, cut net purchases almost in half to $760 million from $1.5 billion in the first quarter.

3/ Interest rate analysis in this report is based on data provided in World Financial Market, Morgan Guaranty Trust Company.

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$1,787	$37,276	$1,463	$38,739
Switzerland	134	1,252	72	1,324
West Germany	1,546	18,836	760	19,596
United Kingdom	(97)	8,427	785	9,212
Asia	(618)	45,837	(279)	45,558
Japan	423	14,333	1,027	15,360
"Other Asia"*	(1,293)	28,139	(1,646)	26,493
All Countries	$802	$91,858	$3,143	$95,001

Source: U.S. Treasury

* Treasury has discountinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

Japanese investors were unusually enthusiastic purchasers of Treasuries in the second quarter, thus offsetting continued net divestiture by the oil-exporting countries. Japanese investors boosted net purchases to $1.0 billion from $423 million in the first quarter, while the oil-exporting countries escalated net selling of Treasuries to $1.6 billion from $1.3 billion. High U.S. rates are reportedly attracting record outflows of Japanese capital, outweighing in recent months the current account surpluses in Japan's balance of payments.4/ Treasury data indicate that these capital outflows have been invested mainly in Treasuries, as Japanese investors showed minimal interest in other U.S. investments in the second quarter.

4/ "Tokyo shares fall, yen lowest in nearly a year", Financial Times, 7/24/84.

U.S. Investor Activity in Foreign Stocks

Caution has marked the approach to equity investment worldwide in 1984. U.S. investors began to shy away from foreign equity investment in the last quarter of 1983, swinging to net sellers of $354 million in the first quarter of 1984 despite the continued advance of stocks on some major foreign exchanges. The general disinterest in foreign equity investment has continued albeit at a reduced pace in the second quarter as U.S. investors were net sellers of $6 million.

U.S. investors made net purchases of $101 million of European stocks in the second quarter, compared with net sales of $54 million in the first quarter. Nevertheless, much of the reversal in investment posture is based on an over twofold increase in net purchases of U.K. stocks. Net purchases of U.K. stocks jumped to $90 million from $43 million in the first quarter. Even this level of activity, however, is a far cry from the $1.1 billion invested in U.K. stocks in 1983. In addition, U.S. investors sharply reduced net sales of stocks of Netherlands' companies, from $153 million in the first quarter to $42 million in the second. On the other hand, the

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$3,348	$(54)	$3,055	$101
France	311	41	258	24
Netherlands	371	(153)	264	(42)
Switzerland	339	15	237	(5)
United Kingdom	1,719	43	1,864	90
Canada	1,138	(130)	1,045	(17)
Asia	3,153	(235)	2,289	(267)
Japan	2,769	(193)	2,014	(230)
Other	469	65	621	177
All Countries	$8,108	$(354)	$7,010	$(6)

Source: U.S. Treasury

reportedly selective buying of stocks of French companies was reduced by 41% to $24 million in the second quarter from $41 million in the first. The French stock market's performance has been quite strong in light of a weak economy and internal political strife. However, the first quarter advance of the French franc was short-lived and the currency plunged some 11% vis-a-vis the dollar in the second quarter.

The pace of net selling of Canadian stocks slowed considerably in the second quarter. Net sales of $17 million were made, compared to $130 million in the first quarter. The Canadian economy has been subject to increasing pressure since the beginning of the year. Demand for natural resources, which drives the Canadian economy, has not fully picked up on a worldwide basis. In addition, the plight of financing Canada's large federal deficit was exacerbated by rising interest rates in the second quarter. However, the political change in Canada that took place in early summer, John Turner replacing Prime Minister Trudeau, has precipitated an environment that money managers believe will be more supportive of Canada's resource industries.5/ U.S. investors may have reduced net sales in anticipation of a shift in the Canadian government's policies.

Japanese stocks have been in disfavor with U.S. investors since the fourth quarter of 1983, when net sales of $152 million were made. The trend of net divestiture accelerated to $193 million in the first quarter of 1984 and further to $230 million in the second quarter. The high multiples on Japanese stocks have been cited as a primary concern of money managers. In addition, other concerns have been raised over the possible dampening of the all-important Japanese export sector with the liberalization of the Japanese capital markets and expected strengthening of the yen.6/

Carolyn Hildebrandt
Assistant Vice President

5/ "World Stock Market Review", Institutional Investor, 8/84.

6/ "Market notes from around the world," Financial World, 6/27-7/10/84.

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Foreign Activity in U.S. Securities

"Highlights"

1. In the third quarter of 1984, foreign investors escalated their net sales of U.S. equities to $1.6 billion from $473 million in the second quarter. Thus, through the first three quarters of 1984, foreigners were net sellers of $1.5 billion of U.S. equities. This compares with foreign net purchases of $4.9 billion for the first three quarters of 1983.

2. Foreign investors stepped up gross transactions in U.S. equities by 8% to $30.9 billion from the second to third quarter. Nevertheless, at $94.5 billion, activity through September ran 7% below the 1983 level for the same period.

3. Foreign net purchases of corporate bonds rose to $2.3 billion in the third quarter from $67 million in the second. The jump, however, reflects in part the new direct Euro-issues, which previously had not been captured in the Treasury's corporate bond flows.

4. Foreign investors made net purchases of $2.1 billion of U.S. Treasuries in the third quarter, bringing estimated total foreign holdings to $97.1 billion.

5. After making net sales of $360 million of foreign stocks in the first half of 1984, U.S. investors reversed their investment posture and were net buyers of $729 million in the third quarter. While U.S. investors took a more optimistic approach to investment in stocks of European and Canadian companies, much of the renewed interest was directed to Asian companies.

Introduction

In the recently published Delphi study of the securities industry in the late 1980s, participants indicated that the four most important factors influencing foreign investment in U.S. assets are: high real interest rates, political stability, a strong dollar and a favorable economic outlook.1/ In the third quarter of 1984, the dollar faltered only in August in an otherwise steady rise against all major currencies while the stock market also managed to show some steam. However, other factors pointed to a questionable outlook for foreign investment in U.S. equities. Thus, foreign investors accelerated net sales of U.S. equities to $1.6 billion in the third quarter from $473 million in the previous quarter.

The spurt in interest rates in June coupled with robust economic growth heightened investors' concerns over inflationary pressures. Indications during the third quarter that the rapid growth pace of the U.S. economy was slowing did not soothe investors' fears. Indeed, third-quarter real GNP expanded at a modest 1.6% annual rate. In addition, interest rates dropped from their lofty June peaks. Nevertheless, the uncertainty that marked the economic picture prompted foreign investors to make substantial net sales of U.S. equities.

The dollar continued on an upward path over the third-quarter. While most major currencies managed to appreciate vis-a-vis the dollar in August, these gains were negated by the dollar's strong strides in September. On a quarterly basis, the German mark suffered the sharpest depreciation against the dollar, 9.1%, followed by the pound, 8.6%. The Swiss franc depreciated by 7.9%, while the yen and French franc fell between 4% and 5% via-a-vis the dollar. In contrast, the Canadian dollar held fairly steady over the period.

Even the August rebound in an almost year-long slide was not enough to entice foreign investors back into the U.S. equities market. The August market pickup, largely maintained in September, put the market indices at an upward quarterly change for the first time in 1984. The NYSE and S&P 500 indices gained over 8%, respectively, while the Dow Jones Industrial Average increased by almost 7%.

1/ Keys to a Changing Securities World, Securities Industry Association and Arthur Andersen & Co., February, 1985.

Foreign and Institutional Participation in U.S. Equities

The participation of foreign investors in the U.S. equities market as a percentage of net inflows of institutions and foreigners peaked in 1975. Nevertheless, foreign investors have played a significant role in the equities market in the 1980s, with net purchases averaging $5.1 billion annually in the 1980-83 period. The marked increase in net purchases by private pension funds and state and local retirement systems in 1983 distinctly overshadowed foreign participation. Nevertheless, foreign buying of U.S. equities has been an important source of strenghth to the equity prices, trailing only private pension funds and state/local retirement systems in the accumulation of equities. With net selling in 1984, both pension funds and foreign investors took away an important cushion for equity prices.

TABLE I

FOREIGN PARTICIPATION COMPARED TO INSTITUTIONAL PARTICIPATION IN U.S. EQUITIES
($ millions)

Net Purchases by:	1970	1975	1980	1981	1983	9 mos. to 9/30/84
Private Pension Funds	$ 4,585	$ 5,714	$11,704	$ 7,325	$15,416	$ (6,141)
Mutual Funds	1,225	(1,195)	(1,814)	(571)	622	5,635
Life Insurance Co.	1,795	1,152	315	1,542	4,489	754
Property-Liability Insurance Co.	890	(1,003)	3,153	1,632	2,944	1,535
State and Local Retirement Systems*	2,137	2,048	5,951	8,353	18,865	3,976
Foreign Investors	626	4,672	5,427	5,830	5,423	(1,482)
Total Net Inflows	11,258	11,388	24,736	24,111	47,759	4,277
Percent of Foreign Participation	5.6%	41.0%	21.9%	24.2%	11.4%	--

SOURCES: U.S. Department of Commerce, U.S. Treasury and Federal Reserve.
*Book Value

Foreign Activity in U.S. Equities

Gross Activity

Foreign investors stepped up gross transactions in U.S. equities by 8% in the third quarter to $30.7 billion from $28.7 billion. The bulk of the stepped up activity stemmed from Asia, as transactions were accelerated by 20% to $4.7 billion from $3.9 billion in the second quarter. European investors increased activity by 5% and Canadians, by 8%. Despite the third-quarter pickup, 1984 activity at the end of September ran 7% below the 1983 level of $102.2 billion for the same period.

Net Purchases

Not only did foreign investors maintain the net selling posture of the second quarter, but net sales of U.S. equities were escalated over threefold in the third quarter to $1.7 billion. Thus, foreign investors have been net sellers of $1.5 billion of U.S. equities through the first three quarters of 1984, a highly unusual development for these investors. Although Canadian investors increased net purchases to $466 million and Latin American and Caribbean investors remained net purchasers, this activity did not offset the large sales stemming from Europe. The pace of net selling by European investors was stepped up from $390 million in the second quarter to $1.7 billion in the third. Asian investors also contributed to the net divestiture position of foreign investors in the third quarter, increasing net sales by 73% to $743 million.

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984 Second Quarter		1984 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$15,952	$(390)	$16,761	$(1,731)
Belgium-Luxembourg	568	0	690	(40)
France	1,362	134	1,240	(140)
Germany	1,119	(81)	1,689	(227)
Netherlands	1,009	(137)	865	(131)
Switzerland	4,906	(250)	4,762	(1,014)
United Kingdom	6,458	(138)	6,929	(139)
Canada	4,034	170	4,356	466
Latin America & Caribbean	4,432	144	4,293	165
Bermuda	1,376	4	1,645	45
Netherlands Antilles	2,039	153	1,575	131
Asia	3,900	(430)	4,661	(743)
Hong Kong	551	(69)	826	(258)
Japan	433	1	791	(37)
"Other Asia"*	2,439	(441)	2,739	(477)
Total All Countries	$28,693	$(473)	$30,860	$(1,564)

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

European Investors

In the third quarter, European investors made massive sales of U.S. equities, $1.7 billion, compared with $390 million in the second quarter. Although net sales were reported by all major European countries, the large net sales of $1.0 billion by Swiss investors accounted for almost 60% of the quarterly figure. German investors also increased net sales of U.S. equities, from $81 million in the second quarter to $227 million in the third. Activity stemming from the Netherlands and U.K. remained at the same level on a quarterly basis, net sales of around $130 million. French investors, the only major European net purchasers of U.S. equities in the second quarter, swung to net sellers of $140 million in the third.

U.S. equities fell into disfavor with German investors in the second quarter, and this investment posture persisted through the third quarter. German investors escalated net sales to $227 million in the third quarter from $81 million. Although growth forecasts for the German economy were reduced after settlement of the metalworkers' strike in June, German investors evidently were more interested in domestic and other investment prospects than in U.S. equity investment. Confidence in domestic investment would have been well rewarded as the Frankfurt exchange, after a sharp dip at the beginning of the third quarter, climbed steadily to peak on December 1. Benefiting in part from the reversal of a two-year long net capital outflow, the German stock exchanges reportedly enjoyed a good year in 1984, with investors lured back into stocks from fixed income securities by the promise of higher returns based on increased corporate earnings, rock-bottom inflation and declining interest rates.2/

During the first nine months of 1984, U.K. investors were consistent net sellers of U.S. equities, averaging around $130 million quarterly. The pound suffered a particularly sharp depreciation, 8.6%, against the dollar during the third quarter, driven down by plentiful oil supplies and domestic labor disputes. To prop up the tumbling pound, the Bank of England reluctantly boosted interest rates. Although the rate increase was temporary, it exacerbated concerns over the underlying strength of the British economy and unacceptably high unemployment. Thus, given a questionable outlook for equity investment in the U.S. and U.K., British investors sought fixed income returns. U.K. investors showed considerable interest in U.S. corporate and Treasury bonds in the third quarter. (Elimination of the foreign withholding tax on interest was helpful.)

2/"World's Stock Exchanges Experience a Difficult Year," The New York Times, 12/31/84

Swiss investors made substantial divestitures of U.S. equities in the third quarter. Net sales of $1.0 billion were made, compared with $250 million in the second quarter . On the other hand, French investors reversed their investment posture from net purchasers of $134 million in the second quarter to net sellers of $140 million in the third. During the third quarter, there was anticipation that the French government would ease the foreign exchange premium mechanism that imposes a punitive exchange rate on those buying foreign securities.3/ Nevertheless, although some French investors may have adopted a wait-and-see approach, others were quick to join most European investors in making net divestitures of U.S. equities.

Canadian Investors

Through the third quarter, Canadian investors maintained their position as the largest foreign purchasers of U.S. equities in 1984. After a dip in net purchases to $170 million in the second quarter, net purchases rose to $466 million in the third, bringing total net purchases by Canadian investors to $1.3 billion for the first nine months of 1984. Although the outcomes were expected, the change in Canadian leadership in June and the upcoming September national elections set off public debate on interest and exchange rate policy. Thus, given an uncertain policy atmosphere and a languishing domestic stock market, Canadian investors increased investment in U.S. equities.

Asian Investors

Asian investors escalated net sales of U.S. equities by 73% to $743 million in the third quarter from $430 million. Large net sales, $258 million, from Hong Kong accounted for the bulk of this amount. Net sales by the oil-exporting countries in the third quarter were on par with those in the second, averaging about $460 million quarterly. Saudi Arabia alone was reportedly forced to draw down some $10 billion in reserves in the 1983-84 financial year.4/ With oil production and revenues at depressed levels and a $13 billion deficit projected for the current fiscal year, it is likely that the oil-exporting countries will continue to make net divestitures of U.S.-dollar denominated assets, which represent the main component of their foreign reserve assets.

3/"Paris likely to ease foreign exchange curb," Financial Times, 10/26/84.

4/"Oil producers begin to draw on investments," Arab Banking, Financial Times Survey, 10/15/84.

Foreign Activity in U.S. Corporate Bonds

Foreign net purchases of corporate bonds escalated from $67 million in the second quarter to $2.3 billion in the third. The jump, however, reflects in part the incorporation of new direct Euro-issues into Treasury's corporate bond flows. Therefore, due to this accounting change, foreign activity in corporate bonds is not strictly comparable on a quarter-to-quarter basis. While net purchases were reported for most major countries, the large purchases of $1.3 billion by U.K. investors accounted for most of the total third-quarter figure.

Net purchases by European investors rose from $291 million to $1.8 billion in the third quarter, with U.K. investors fueling the increased activity. U.K. investors showed considerable interest in both corporate bonds and U.S. Treasuries in the third quarter. U.S. corporate bond yields peaked in June at 14.50% and gradually declined to 12.88% by the end of September.[5/] While U.K. rates spurted from June to July, U.S. rates were some 100 basis points higher than U.K. rates through much of the third quarter.

TABLE III

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1984 Second Quarter		1984 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$1,981	$291	$4,634	$1,814
Belgium-Luxembourg	126	(48)	124	12
Germany	666	292	1,158	374
Switzerland	286	14	393	39
United Kingdom	682	(8)	2,636	1,316
Asia	1,375	(293)	1,472	386
Japan	275	131	569	223
"Other Asia"	919	(439)	732	74
Total All Countries	$4,117	$67	$6,942	$2,310

Source: U.S. Treasury

5/ Interest rate analysis in this report is based on data provided in World Financial Markets, Morgan Guaranty Trust Company.

Similar to U.K. investors, other European investors made net purchases of Treasuries. German investors increased net purchases 28% to $374 million, and Swiss investors escalated net purchases to $39 million from $14 million. Investors located in the Belgium - Luxembourg countries swung from net sellers of $48 million to net purchasers of $12 million.

In the third quarter, Asian investors reversed their position to net purchasers of $386 million of corporate bonds from net sellers of $293 million. The reversal in investment posture is based largely on the cessation of net selling by the oil-exporting countries. In a departure from recent investment patterns, the oil-exporting countries purchased $74 million of corporate bonds, in contrast to net sales of $439 million in the second quarter. Japanese investors, who purchased $284 million of corporate bonds in the first half of 1984, stepped up net purchases to $223 million in the third quarter.

Foreign Activity in U.S. Treasury Notes & Bonds

In the third quarter, foreign net purchases of U.S. Treasuries dipped to $2.1 billion from $3.1 billion in the second quarter. However, in the second quarter, the large net purchases of international organizations (not shown in Table IV) accounted for the bulk of the total figure. So too, in the third quarter, large net sales of $3.0 billion by these organizations considerably offset the net purchases made by other foreign investors. Foreign holdings of U.S. Treasuries are estimated at $97.1 billion at the end of September.

European net purchases of U.S. Treasuries soared to $4.4 billion from $1.5 billion. Net purchases by U.K. investors jumped from $785 million in the second quarter to $2.8 billion. Other European countries evidenced a marked pickup of interest in U.S. Treasury investment. In contrast to prior quarters, when some 90% of European activity in Treasuries originated in the three major countries shown in Table IV, about 21% resulted from other countries in the third-quarter. For example, $184 million was purchased by Austrian investors, $157 million by French investors, and $418 million by the Treasury category "Other Europe."

Investors from Japan and the oil-exporting countries moderated their investment approach to Treasuries in the third quarter. Net purchases by Japanese investors dropped 14% to a still-substantial $885 million from $1.0 billion. Nevertheless, through the first three quarters of 1984, much of the reported large Japanese capital outflow has been invested in Treasuries, with net purchases of $2.3 billion made. In contrast, investors from the oil-exporting countries made net divestitures of $867 million in the third quarter, compared with $1.6 billion in the second.

TABLE IV

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1984 Second Quarter		1984 Third Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$1,463	$38,739	$4,360	43,099
Switzerland	72	1,324	436	1,760
West Germany	760	19,596	180	19,776
United Kingdom	785	9,212	2,787	11,999
Asia	(279)	45,558	89	45,647
Japan	1,027	15,360	885	16,245
"Other Asia"*	(1,646)	26,493	(867)	25,626
Total All Countries	$3,143	$95,001	$2,075	97,076

Source: U.S. Treasury

* Treasury has discountinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

U.S. Investor Activity in Foreign Stocks

After making net sales of $360 million of foreign stocks in the first half of 1984, U.S. investors reversed their investment posture and made net purchases of $729 million in the third quarter. While U.S. investors took a more optimistic approach to investment in stocks of European and Canadian companies, much of the quarterly figure stemmed from renewed interest in Asian companies. Unlike the U.S. stock market, major stock markiets in some foreign countries embarked on a stready upward path over the second half of 1984. We continue to believe that the Treasury numbers, while indicative of the trend of U.S. investment in foreign stocks, do not necessarily reflect the full magnitude of that investment.

U.S. investors stepped up net purchases of stocks of European companies to $337 million in the third quarter from $101 million in the second. Interest in European stocks was widespread, with net purchases made in all major countries. Accounting for much of the increased third-quarter figure was the swing from net sellers to net purchasers of $82 million and $46 million of stocks of companies located in the Netherlands and Switzerland, respectively. Moreover, U.S. investors

boosted net purchases of French stocks by 42% to $34 million from $24 million. Net purchases of U.K. stocks were increased by 10% to $99 million.

U.S. investors' massive sales of Japanese stocks, $423 million in the first half of 1984, dwindled to a moderate $50 million in the third quarter. While the Japanese stock market recovered somewhat from its steep second-quarter plunge, U.S. investors adopted a wait-and-see approach, possibly assessing the implications of the liberalization of Japan's financial market. However, net purchases of $234 million of stocks of Hong Kong companies, not shown in Table V, are largely reflected in the Asian figure. The volatile Hong Kong index registered a swift drop from April to mid-July as negotiations on the Colony's future bogged down. However, given the settlement of some political uncertainties and a reasonably good economic outlook, U.S. investors took part in the market rally of the second half of 1984.6/

TABLE V

GROSS ACTIVITY AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984 Second Quarter		1984 Third Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$3,055	$101	$3,093	$337
France	258	24	186	34
Netherlands	264	(42)	290	82
Switzerland	237	(5)	266	46
United Kingdom	1,864	90	1,961	99
Canada	1,045	(17)	1,088	44
Asia	2,289	(267)	2,250	246
Japan	2,014	(230)	1,692	(50)
Other	621	177	414	102
Total All Countries	$7,010	$(6)	$6,845	$729

Source: U.S. Treasury

Carolyn Hildebrandt
Assistant Vice President

6/"Asian Investors Wary of U.S. Economy," The Wall Street Journal, 1/2/85

SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
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Foreign Activity in U.S. Securities

"Highlights"

1. For the first time since 1968 when foreign investors became active participants in the U.S. equity market, annual transactions resulted in net sales of U.S. stock. Foreign investors were net sellers of $2.9 billion of U.S. equities in 1984, in contrast to net purchases of $5.4 billion in 1983. Preliminary data indicate that foreign investors continued to be net sellers in the first quarter of 1985.

2. Nevertheless, the magnitude of foreign gross activity in U.S. equities, $123.7 billion in 1984, remains impressive. Of the value of shares publicly traded on the NYSE, foreign investors accounted for an estimated 9.5% in 1984, compared with about 10.5% in 1983.

3. Based in part on the incorporation of new direct Euro-issues into the Treasury data, foreign net purchases of U.S. corporate bonds soared to $11.9 billion in 1984 and gross activity skyrocketed to $32.6 billion.

4. The repeal of the 30% withholding tax had a marked influence on the level of foreign investment in U.S. Treasury notes and bonds. In 1984, foreign holdings of Treasuries jumped by $21.5 billion to $110.4 billion, compared with an increase of $5.4 billion in 1983.

5. Given the revival of U.S. interest in foreign stocks in the second half of the year, net purchases of $1.1 billion were made in 1984. Nevertheless, 1984 net purchases represent a 71% slide from the record of $3.8 billion set in 1983. Undoubtedly, the strength of the U.S. dollar dampened the enthusiasm of U.S. investors for foreign equities.

Introduction

Foreign investors juggle a mix of factors in determining whether or not to invest in U.S. equities. Two major positive factors were provided in 1984 for investment in dollar-denominated assets -- a rising dollar and strong U.S. economic growth. However, while these and other factors were favorable for investment in dollar-denominated assets overall, certain other factors weighed against investment in U.S. equities in particular. A depressed stock market, growing federal deficit and intermittent fears of a resurgence of inflationary pressures gave rise to a pessimistic outlook for U.S. equities. Foreign investors were quick to change investment strategy in 1984. After making net purchases of $555 million in the first quarter, foreign investors sold $3.3 billion of U.S. equities over the remainder of the year. Thus, for the first time since 1968 when foreign investors became active participants in the market, annual activity resulted in net sales. Foreign investors made net sales of $2.9 billion of U.S. equities in 1984, in contrast to net purchases of $5.4 billion in 1983.

Preliminary data indicate that foreign investors were net sellers in the first quarter of 1985. While the U.S. stock market rallied early in the quarter, the dollar became increasingly subject to volatile swings. Anticipation of a weaker dollar may have prompted foreigners to maintain a net selling posture toward U.S. equities.

Worldwide economic growth in 1984 was somewhat stronger than anticipated. Led by the U.S., performance of the world economy as measured by the OECD was the best for some years: 4 1/2% output growth and 9% world trade volume growth were the fastest growth rates since 1976 and overall inflation was 5%, the lowest since 1972.[1/] Exports, a large part of which flowed to the U.S., fueled much of the global recovery. Should the U.S. economic expansion slow and the dollar weaken, the problem of encouraging worldwide economic growth could become a serious one for policymakers.

The strong dollar has been a two-edged sword for many countries. Recoveries of most major countries have been export-led, fueled in part by exports to the U.S. For example, Western Europe's exports to the U.S. as a percent of GNP increased by almost 32% in the period January-October 1984.[2/] On the other hand, the dollar, which touched record

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1/ OECD Economic Outlook, December 1984.

2/ World Financial Markets, Morgan Guaranty Trust Company, December 1984.

highs against almost every foreign currency in 1984, has attracted record capital outflows into U.S. assets, which has helped to finance the federal deficit.

Exchange Rates

From year-end 1983 to year-end 1984, the dollar continued to appreciate almost relentlessly against all major currencies, quite dramatically in some cases. The largest loss vis-a-vis the dollar was sustained by the British pound, which plunged 20% in 1984 after weakening 10% in 1983. Likewise, the Swiss franc's depreciation doubled in 1984 to 16%, from the 1983 falloff of 8%. The German mark gave up almost 14% in 1984, and the French franc lost 13%. In 1983, the Canadian dollar and the Japanese yen put up the best fight against the dollar. However, the yen, which was the only currency that had a slight edge, 1%, over the dollar in 1983, suffered an 8% setback in 1984 and the Canadian dollar depreciated 5%.

Stock Market Indices

The performance of the U.S. stock market in 1984 was unimpressive. The sharpest decline in the stock market occurred in the first half of the year, with the market recouping its loss in the second half and inching up to a meager gain by year-end. The NYSE and the S&P 500 indices gained slightly more than 1% by year-end, while the DJI Average dropped about 4%.

Foreign Activity in U.S. Equities

Gross Activity

In 1984, gross foreign activity in U.S. equities declined by 8% to $123.7 billion from 1983's total of $134.1 billion. Nevertheless, the magnitude of gross foreign transactions in U.S. equities in both years is impressive. Foreign transactions averaged an annual $76.9 billion in the 1980-83 period. Of the value of shares publicly traded on the NYSE, foreign investors accounted for an estimated 9.5% in 1984, compared with about 10.5% in 1983.

Net Purchases

For the first time since 1968 when foreigners became a force in the U.S. equities market, annual activity resulted in net selling. Foreign investors sold $2.9 billion of U.S. equities in 1984, in contrast to net purchases of $5.4 billion in 1983. Although not all major regions made net sales, the large-scale net selling stemming from Europe and Asia dwarfed net purchases from Canada, Latin America, and the Caribbean.

European investors shifted to net sellers of $3.0 billion of U.S. equities in 1984 from net purchasers of $4.0 billion in the prior year. On the other hand, the $2.4 billion of net Asian sales represented an almost six-times acceleration of the net sales of $413 million made in 1983. Net purchases by Latin American and Caribbean investors dropped 7% to $493 million in 1984. Canadian investors were the only major foreign investors to increase net purchases of U.S. equities in 1984.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1983		1984	
	Gross	Net	Gross	Net
Europe	$ 80,465	$3,979	$ 68,957	$(2,992)
Belgium-Luxembourg	2,944	(106)	2,678	(58)
France	7,989	(97)	5,844	(405)
Germany	7,535	1,045	6,185	(50)
Netherlands	4,029	(109)	3,794	(315)
Switzerland	26,192	1,324	20,295	(1,490)
United Kingdom	29,205	1,799	28,082	(664)
Canada	16,423	1,151	16,846	1,673
Latin America & Caribbean	14,295	529	17,338	493
Bermuda	5,311	203	6,037	83
Netherlands Antilles	4,569	77	6,931	461
Asia	21,307	(413)	18,214	(2,376)
Hong Kong	3,080	164	2,866	(539)
Japan	3,257	273	2,718	(102)
"Other Asia"*	13,928	(808)	11,107	(1,998)
Total All Countries	$134,130	$5,410	$123,713	$(2,937)

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, the United Arab Emirates

Note: For 1984, net data include latest revisions and gross transactions are unrevised quarterly figures. For 1983, all data are final. This applies to all tables unless otherwise noted.

European Investors

All major European countries contributed to the overall net selling investment posture of the region in 1984. European investors were net purchasers of U.S. equities only in the first quarter of 1984. Swiss, U.K. and German investors made the most dramatic reversals in investment position. After making net purchases of over $1 billion each of U.S. equities in 1983, these three countries were net sellers of varying amounts in 1984. French investors sold $405 million and Dutch investors over $300 million of equities in 1984, compared with net sales of about $100 million each in 1983. Net sales stemming from the Belgium-Luxembourg countries actually moderated in 1984, to $58 million from $106 million.

U.K. investors were consistent quarterly net sellers of U.S. equities in 1984, with activity cumulating in net sales of $664 million. In contrast, U.K. investors, traditionally the largest net purchasers of U.S. equities, made purchases of $1.8 billion in 1983. The U.K. stock market, after a sharp dip in mid-year, rose some 27% in 1984.3/ Given fairly good prospects for continued economic growth and a rising stock market over much of the year, British investors may have sought domestic equity investment. As for dollar-denominated portfolio investment, British investors made massive purchases of Treasuries and corporate bonds.

German investors sold $50 million of U.S. equities in 1984, in contrast to record net purchases of $1.0 billion in 1983. While the German stock market gained moderately in 1984, other factors may also have prompted German investors to consider domestic investments. The German stock market has become more active in recent years than in the past. Tax changes, a rising market and the decision by some big family firms to go public halted the long-term decline in the number of German shares traded.4/ In 1984, 19 companies issued new shares, compared with 10 in 1983 and 3 in 1982. International competitive pressures have made German authorities more cognizant of the need to loosen restrictions on domestic markets.

Just as Swiss investors made record net purchases of $1.3 billion in 1983, they made net sales of $1.5 billion in 1984. The Swiss economy is enjoying a modest recovery, and the National Bank is holding to a tight monetary policy. Despite

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3/ Based on data as reported in Business Conditions Digest, U.S. Department of Commerce, 2/85.

4/"Pieces of eight", The Economist, 3/2/85.

considerable downward pressure on the Swiss franc, which fell 16% against the dollar in 1984, the Swiss authorities were reluctant to intervene in foreign exchange markets. Credit demands from an expanding economy added to a firm monetary policy helped to push domestic interest rates up over the year. Swiss investors may have turned their attention to domestic fixed income investments.

TABLE II

NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984 First Quarter	1984 Second Quarter	1984 Third Quarter	1984 Fourth Quarter
Europe	$ 311	$(390)	$(1,731)	$(983)
Belgium-Luxembourg	20	0	(40)	(42)
France	(173)	134	(140)	(137)
Germany	361	(81)	(227)	(104)
Netherlands	32	(137)	(131)	(92)
Switzerland	186	(250)	(1,014)	(413)
United Kingdom	(130)	(138)	(139)	(148)
Canada	708	170	477	331
Latin America & Caribbean	181	144	165	8
Bermuda	144	4	45	(110)
Netherlands Antilles	23	153	131	160
Asia	(582)	(430)	(743)	(592)
Hong Kong	(80)	(69)	(258)	(133)
Japan	39	1	(37)	(105)
"Other Asia"	(604)	(441)	(477)	(477)
Total All Countries	$555	$(473)	$(1,564)	$(1,223)

Source: U.S. Treasury

Note: Quarterly data unrevised.

Net sales of U.S. equities by French investors escalated to $405 million in 1984 from $97 million in 1983. The swing from reflationary to deflationary trends has taken its toll on the French economy. Economic growth lags that of the other major industrialized countries, while inflation of about 7.5% is one of the highest in comparison. Nevertheless, the profits picture for many French companies has brightened with the recovery. In addition, since 1982, when investors recognized that President Mitterand's government intended to strengthen France's financial markets rather than hinder them, the Paris bourse index has more than doubled as has turnover.5/

Canadian Investors

In 1984, Canadians were the only major foreign investors to increase net purchases of U.S. equities. These investors boosted net purchases by 45% from $1.2 billion in 1983 to $1.7 billion. While attractive returns were available on domestic fixed income investment, the Canadian stock market suffered a double-digit setback in 1984. For those investors seeking equity investment, the U.S. market offered somewhat better prospects.

Latin American & Caribbean Investors

Net purchases of U.S. equities by Latin American and Caribbean investors dropped 7% to $493 million in 1984 from $529 million in 1983. Netherlands Antilles investors substantially stepped up net purchases to $461 million in 1984 from $77 million in 1983. On the other hand, investors located in Bermuda reduced net purchases by 59% to $83 million from $203 million.

Asian Investors

Asian investors dramatically increased net sales of U.S. equities in 1984. Net sales of $2.4 billion were made, compared to $413 million. The activity of the oil-exporting countries has dominated the trend of investment from the Asian region in recent years and 1984 was no exception. While investors from both Hong Kong and Japan were net sellers of U.S. equities, the oil-exporting countries made massive net divestitures of $2.0 billion, compared to $808 million in 1983. The further softening of oil prices in 1984 necessitated the escalated drawing down of assets by the oil-exporting countries to fund internal development. Hong Kong and Japanese investors, both net purchasers in 1983, swung to net sellers of $539 million and $102 million of U.S. equities, respectively.

5/ "Plus ca change", The Economist, 3/30/85.

Foreign Activity in U.S. Corporate Bonds

In the fourth quarter of 1984, foreign investors purchased over $9 billion of U.S. corporate bonds. While Treasury data in the latter half of the year reflect the incorporation of new direct Euro-issues, other factors also contributed to increased foreign attention to U.S. corporate bonds. Inflationary expectations were moderating, long-term interest rates were declining, and the dollar remained strong. A larger portion of foreign capital inflows subsequently took the form of portfolio investment, with the U.S. bond market attracting particular attention in November and December because of relatively attractive yields and prospects for capital appreciation.6/

Thus, based in part on an accounting change, foreign net purchases of corporate bonds soared to $11.9 billion in 1984. Similarly, gross activity skyrocketed to $32.6 billion. In comparison, net purchases were $918 million in 1983 and gross activity, $19.0 billion. U.K. investors accounted for a startling 72%, or $8.6 billion, of total foreign net purchases in 1984.

TABLE III

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1983		1984	
	Gross	Net	Gross	Net
Europe	$ 11,933	$805	$ 23,137	$11,026
Belgium-Luxembourg	371	(159)	549	(86)
Germany	3,155	285	4,319	1,555
Switzerland	2,281	537	2,606	610
United Kingdom	4,729	211	14,185	8,585
Asia	4,112	(154)	5,885	524
Japan	1,289	463	2,019	747
"Other Asia"	2,372	(768)	3,031	(445)
All Countries	$18,988	$918	$32,631	$11,887

Source: U.S. Treasury

6/ "Treasury and Federal Reserve Foreign Exchange Operations," Quarterly Review, Federal Reserve Bank of New York, Spring 1985.

While turning away from U.S. equity investment, U.K. investors were avid purchasers of corporate bonds, particularly in the fourth quarter. When U.S. corporate bond rates peaked in June, the yield differential between U.S. and U.K. bonds favored U.S. investment by 181 basis points. By September, the differential was down to 114 basis points. Although the differential narrowed substantially over the fourth quarter, U.K. investors purchased $7.0 billion of corporate bonds. German investors also made large purchases in 1984. Again, based mainly on fourth-quarter activity, German investors purchased $1.6 billion of U.S. corporate bonds.

Asian investors swung from net sellers of $154 million of corporate bonds in 1983 to net purchasers of $524 million in 1984. Japanese investors, who favored Treasuries in 1984, purchased $747 million of corporate bonds compared with $463 million in 1983. Net divestitures by the oil-exporting countries moderated somewhat in 1984, to $445 million from $768 million in 1983.

Foreign Activity in U.S. Treasury Notes & Bonds

The July 1984 repeal of the U.S. 30% foreign withholding tax had a marked influence on the level of foreign investment in U.S. Treasury notes and bonds. In 1984, foreign holdings jumped by $21.5 billion to $110.4 billion, compared with an increase of $5.4 billion in 1983. Net foreign acquisitions of $17.1 billion of Treasuries in the last six months of 1984 compare with $3.7 billion is the first half. Net purchases in 1984 represent the second largest acquisition of Treasuries since 1977, when a record of $22.8 billion was set. However, in 1977, 90% of the acquisitions was made by foreign central banks. In contrast in 1984, about 75% of foreign acquisitions were made by Treasury's category "other foreigners", an unusually high 23% by international and regional organizations, and 2% by central banks.

U.S. Treasury issues provided handsome returns in 1984. Yields on long-term issues climbed some 200 basis points over the first six months of the year to peak at 13.58% in June and, subsequently, declined to end the year at 11.61%.[7/] The path of yields on Treasury bills was somewhat similar, with a peak of 11.63% reached in June and a low of 8.22% for the year in December. In contrast, yields on government issues in most foreign countries remained lower than those in the U.S. over the year. Attractive returns, liquidity, and the relative safety of U.S. Treasury issues combined with the removal of the withholding tax prompted foreigners to make near-record purchases of U.S. Treasuries.

7/ Based on data from World Financial Markets, Morgan Guaranty Trust Co.

TABLE IV

NET FOREIGN PUCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1983		1984	
	Net Purch.	Estimated Holdings	Net Purch.	Estimated Holdings
Europe	$ 7,960	$35,509	$11,061	$ 46,570
Switzerland	38	1,118	635	1,753
West Germany	3,725	17,290	2,958	20,248
United Kingdom	1,966	8,515	5,226	13,741
Asia	(3,535)	46,026	2,364	48,390
Japan	2,315	13,911	6,062	19,973
"Other Asia"	(5,419)	29,410 1/	(6,277)	23,133 1/
Nonmonetary Int'l & Regional Organizations	531	5,114	4,979	10,093
All Countries	$5,427	$88,932	$21,462	$110,394

Source: U.S. Treasury

1/ Treasury has discontinued publication of estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

European holdings of Treasuries increased by $11.1 billion, or 31%, to $46.6 billion. U.K. investors purchased $5.2 billion, compared with $2.0 billion in 1983. On the other hand, net purchases by German investors, who were the largest acquirers of Treasuries in 1983, dropped 21% to $3.0 billion from $3.7 billion.

The most substantial acquisitions of Treasuries in 1984, $6.1 billion, were made by Japanese investors. While these investors shied away from U.S. equities and corporate bonds, a good portion of the reportedly record capital outflow from Japan was invested in Treasury notes and bonds. Net capital outflow from Japan in 1984 totaled $49.8 billion--$10 billion more than the total of the preceding three years.8/ The

8/ "Japan Invests Huge Sums Abroad", New York Times, 3/11/85.

momentum behind the accelerated Japanese outflow is partly explained by the deregulation of Japanese banking regulations. However, the continued massive divestiture of Treasuries, $6.3 billion, by the oil-exporting countries offset Japanese activity. Thus, net purchases for the Asian region of $2.4 billion reflect acquistions by other Asian countries not shown in Table IV. For example, investors located in Singapore and Hong Kong acquired $1.4 billion and $660 million of Treasuries, respectively.

U.S. Activity in Foreign Stocks

Although U.S. investors were distinctly wary of foreign stocks in the first half of 1984, their attitude changed in the second half of the year as many major foreign stock markets began an upswing. Given the revival of U.S. interest in foreign stocks in the last six months of 1984, total activity for 1984 resulted in net purchases of $1.1 billion. Nevertheless, 1984 net purchases represent a 71% slide from the record $3.8 billion set in 1983. According to the annual survey by InterSec Research Corp., U.S. plan sponsors and managers of internationally diversified ERISA funds had $15.7 billion invested in overseas assets at year-end 1984.

TABLE V

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1983		1984	
	Gross	Net	Gross	Net
Europe	$13,633	$2,211	$13,002	$ 922
France	1,440	392	995	127
Netherlands	1,154	228	1,217	(55)
Switzerland	1,778	84	1,291	75
United Kingdom	6,483	1,125	7,557	557
Canada	4,970	464	4,418	(188)
Asia	9,397	1,207	10,588	(4)
Japan	7,974	880	8,971	(331)
Other	2,327	(117)	1,970	354
All Countries	$30,327	$3,765	$29,978	$1,084

Source: U.S. Treasury

Note: For 1984, all data unrevised.

U.S. net purchases of European stocks dropped 58% to $922 million in 1984 from $2.2 billion in 1983. Net purchases of French stocks were cutback 68% to $127 million in 1984, while purchases of Swiss stocks were reduced 11% to $75 million. U.S. investors paid considerable attention to U.K. stocks in the fourth quarter, with net purchases of $325 million accounting for 58% of the total of the year, $557 million. U.S. investors sold $55 million of Dutch stocks, but the annual figure is based mainly on net sales of $195 million in the first half of the year. Similar to many other foreign exchanges, the Amsterdam stock market reached the low point for the year in June and gained during the remainder of the year. U.S. investors caught the uptrend, purchasing $140 million of Dutch stocks. In U.S. dollar terms, the Dutch stock market outperformed all other European markets in 1984.

Although the change in the Canadian leadership in mid-year promised a more encouraging atmosphere for foreign investors, Canadian stocks were out of favor with U.S. investors in 1984. Net sales of $188 million were made, in contrast to net purchases of $464 million in 1983. The Canadian deficit stands at a substantial $25 billion, and high unemployment is a major concern. With its heavy weighting of natural resource stocks, the Canadian stock market had a lackluster year, declining 13% from year-end to year-end.

TABLE VI

NET PURCHASES OF
FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984 First Quarter	1984 Second Quarter	1984 Third Quarter	1984 Fourth Quarter
Europe	$ (54)	$101	$337	$538
France	41	24	34	28
Netherlands	(153)	(42)	82	58
Switzerland	15	(5)	46	19
United Kingdom	43	90	99	325
Canada	(130)	(17)	44	(85)
Asia	(235)	(267)	246	252
Japan	(193)	(230)	(50)	142
Other	65	177	102	10
All Countries	$(354)	$ (6)	$729	$715

Source: U.S. Treasury

Note: Quarterly data unrevised.

In 1984, U.S. investors swung to net sellers of $4 million of stocks of Asian companies from net purchasers of $1.2 billion in 1983. The change in investor attitude toward Japanese stocks accounts for this reversal. U.S. investors sold $331 million of Japanese stocks in 1984, in contrast to net purchases of $880 million in 1983. Offsetting much of the net divestiture of Japanese stocks were purchases of $285 million of stocks of Hong Kong companies in the second half of the year. Although continuing its traditional volatility, the Hong Kong market was the top performing foreign market in U.S. dollar terms, gaining 39.3% over the year.9/

Carolyn Hildebrandt
Assistant Vice President

9/ "The Year Eight Foreign Markets Outpaced Wall Street", Barron's, 1/7/85.

SIA

Foreign Activity

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Foreign Activity in U.S. Securities

"Highlights"

1. Although certain investment fundamentals shifted from fourth-quarter 1984 to first-quarter 1985, foreign investors did not change their investment posture toward U.S. equities. Foreign investors were net sellers of U.S. equities to the tune of slightly more than $1 billion on a quarterly basis. Since the second quarter of 1984, foreigners have been consistent net sellers of U.S. equities, with sales totaling about $4.4 billion.

2. Foreign gross transactions in U.S. equities was a substantial $38.0 billion in the first quarter, an increase of 31% from fourth-quarter 1984's level of $28.9 billion. Nevertheless, the rise in market activity slightly outpaced foreign participation.

3. Based on continued exceptional interest from U.K. investors, foreign net purchases of U.S. corporate bonds were stepped up 8% in the first quarter to $9.9 billion from $9.2 billion in the last quarter of 1984.

4. Foreign interest in acquiring U.S. Treasuries diminished sharply in the first quarter, as large-scale sales by foreign central banks dampened buying activity. Net purchases of only $237 million of Treasuries were made, a far cry from the $12.6 billion acquired in the fourth quarter of 1984.

5. As foreign markets surged in the first quarter of 1985, so too did U.S. investment in foreign equities. Gross transactions of $10.0 billion and net purchases of $1.9 billion inched past previous quarterly highs for U.S. participation in foreign stock markets.

Introduction

In 1984, the recorded net capital inflow of the U.S. was $71 billion, more than double the net inflow in 1983.[1/] Although over half this amount was reportedly invested in U.S. corporate and Treasury securities, the U.S. equity market was not the recipient of increased foreign investment in 1984. For the first time since 1968 when foreign investors became a major factor in the U.S. equity market, these investors were net sellers. Foreign net sales of $2.9 billion in 1984 contrasted sharply with net purchases of $5.4 billion in 1983.

Several key factors considered by the foreign investor in determining how to invest his funds changed markedly during the first quarter of 1985. U.S. economic growth, labeled too robust by some observers during much of 1984, slowed to only 0.3% at a real annual rate. The stock market, which stagnated in 1984, rallied in the first month of the new year and held onto its gains to close the quarter up tenuously. However, the relentless advance of the dollar appeared to be coming to an end, with the dollar increasingly subject to volatile swings. Foreign investors continued to make net divestitures of U.S. equities in the first quarter at the same pace as the last quarter of 1984, a shade over $1 billion.

Preliminary data for the first two months of the second quarter indicate that foreign investors continued to make net sales of U.S. equities. However, the magnitude of net selling appeared to drop. After a minor setback in April, the stock market climbed to new highs in June. On the other hand, the weakness of the dollar may have prompted foreign investors to maintain a net selling strategy toward U.S. equities.

The stock market ended the first quarter of 1985 up from year-end 1984, with most of its progress made in January. The NYSE and S&P 500 indices rose by about 8%, while the DJI Average edged up by almost 5%. Thus, the upbeat yet not particularly strong performance of the stock market was not enough to convince foreign investors to alter their investment strategy.

In 1984, the dollar appreciated almost steadily against all major currencies, with gains ranging from 20% against the pound to almost 6% against the Canadian dollar. During the first two months of 1985, the dollar continued to make strides against all major currencies. However, the dollar's uptrend came to a halt in March, producing a mixed picture at the end of the first quarter of 1985. The pound jumped a dramatic 13% against the dollar in March, thus recouping losses from year-end 1984

1/ "U.S. International Transactions in 1984," Federal Reserve Bulletin, May 1985.

and gaining almost 6%. In addition, both the French franc and German mark recovered slightly from year-end. The Canadian dollar slid by over 3% during the quarter, while the yen and Swiss franc suffered minimal losses against the dollar. Moreover, by the end of June, all major currencies with the exception of the Canadian dollar had appreciated vis-a-vis the dollar from their year-end 1984 levels.

Foreign Activity in U.S. Equities

Gross Activity

The magnitude of foreign purchases and sales of U.S. equities in recent years has been impressive. Although gross transactions dipped 8% in 1984 to $123.1 billion from the 1983

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984 Fourth Quarter		1985 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$15,841	$(977)	$20,632	$(1,344)
Belgium-Luxembourg	668	(42)	1,031	20
France	1,171	(137)	1,753	(73)
Germany	1,382	(104)	1,732	(356)
Netherlands	772	(92)	931	(279)
Switzerland	4,137	(413)	5,404	(414)
United Kingdom	7,255	(142)	9,222	(235)
Canada	4,114	331	4,735	213
Latin America & Caribbean	3,920	8	5,397	389
Bermuda	1,350	(110)	1,875	335
Netherlands Antilles	1,440	160	1,919	11
Asia	4,655	(587)	6,422	(441)
Hong Kong	613	(133)	1,048	(256)
Japan	923	(105)	1,944	(191)
"Other Asia"*	2,675	(477)	3,021	(37)
Total All Countries	$28,885	$(1,211)	$37,961	$(1,137)

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

level, foreign investors accounted for an estimated 9.5% of the value of shares publicly traded on the NYSE. In the first quarter of 1985, the pace of foreign transactions escalated by 31% to $38.0 billion from $28.9 billion. Despite this pickup, foreign participation slipped minimally as a percentage of public trading on the NYSE.

Net Purchases

Since the second quarter of 1984, foreign investors have been net sellers of U.S. equities. This investment posture was maintained in the first quarter of 1985, with net sales of $1.1 billion virtually matching net sales of $1.2 billion in the last quarter of 1984. Thus, foreign net sales of U.S. equities total about $4.4 billion since second-quarter 1984. Continued foreign sales of U.S. equities could have implications for future stock market rallies.

On a regional basis, the same investment pattern has persisted for the past four quarters. European and Asian investors have been net sellers of equities, while Canadian and Latin American investors have continued to make net purchases. In the first quarter of 1985, Europeans stepped up net sales to $1.3 billion and Asian investors moderated net selling to $441 million. In contrast, purchases by Canadian investors were reduced to $213 million, while Latin American and Caribbean investors dramatically escalated net purchases to $389 million.

European Investors

U.S. equities fell into disfavor with European investors early in 1984. By year-end, net divestitures of $3.0 billion had been made, with most major European countries contributing to the overall net selling investment position. Little changed in the new year. On a quarterly basis, net sales by European investors picked up by 38% to $1.3 billion in first-quarter 1985 from $977 million in fourth-quarter 1984.

Most European countries remained net sellers of U.S. equities. Germany and the Netherlands significantly increased net sales to $356 million and $279 million, respectively. U.K. investors also stepped up net selling by 65% to $235 million, and Swiss investors maintained a status quo approach, selling about $400 million. French investors cut net sales in half to $73 million from $137 million. Investors from the Belgium-Luxembourg countries were exceptions to the rule, swinging to net purchasers of $20 million from net sellers of $42 million in the fourth quarter.

German investors accelerated net sales of U.S. equities to $356 million in the first quarter of 1985 from $104 million in the previous quarter. The quickened pace of net selling coincides with the surprisingly strong performance of the

German stock market in the first quarter. The Frankfurter stock market index closed the period 7% higher than its 1984 high, with part of the increase reportedly fueled by foreign, particularly U.S., investors.[2/] In addition, West Germany's economic fundamentals point to continued growth in 1985, based on the caveats that U.S. growth does not slow too much nor the mark rise too strongly against the dollar.

A surprising combination of circumstances has made the Paris bourse the internationally best-performing stock market since 1983.[3/] The French Socialist government initiated tax incentives as well as exchange control barriers aimed at curbing capital outflows to encourage investment in domestic markets. Moreover, a more liberal approach has been taken to financial markets and market regulation. French investors were net sellers of U.S. equities in 1983 and 1984. However, although this pattern persisted in the first quarter of 1985, net sales were reduced to $73 million from $137 million. The firmness of the franc in recent months has wiped out the premium which French investors have since 1981 had to pay on buying foreign exchange for foreign securities purchases.[4/] It is possible that French investors are adopting a wait-and-see approach to foreign investment.

The portfolio strategy of U.K. investors took an obvious turn in 1984. These investors made net sales of $664 million of U.S. equities and purchased massive amounts of fixed-income instruments. First-quarter 1985 brought little change in the U.K. approach to U.S. equities. The British pound, after a precipitous drop early in the year, has held firm against the dollar, given a boost in U.K. interest rates. Indeed, the pound gained about 13% from end-December to end-June. With the U.K. equity market starting the year off with a stronger rally than the U.S. market and the pound advancing on the dollar, U.K. investors accelerated net sales of U.S. equities by 65% to $235 million from $142 million in the last quarter of 1984.

Canada

In 1984, Canadian investors were the only major foreign investors to show sustained interest in U.S. equities, purchasing a significant $1.7 billion. This interest carried through the first quarter of 1985 albeit at a reduced rate. Net purchases by Canadian investors dropped 35% to $213 million in the first quarter of 1985 from $331 million in the last quarter of 1984.

2/ "World Stock Market Review," Institutional Investor, 5/85.

3/ "France," Financial Times Survey, 6/26/85.

4/ Ibid.

Canada's economic picture is mixed. Growth in the western provinces will continue to lag so long as commodity prices stay low. Eastern Canada, however, should stay in the forefront of economic expansion, with the manufacturing industry in particular enjoying expansion based on anticipated capital spending plans.[5/] Nevertheless, Canada's depressed natural resource industry has slowed economic progress, dampened the stock market, and dragged down the Canadian dollar.

Latin American & Caribbean Investors

Investors located in Latin America and the Caribbean purchased $493 million of U.S. equities in 1984. In the first quarter of 1985, investors in the Netherlands Antilles dramatically decreased net purchases to $11 million from $160 million in the fourth quarter. In contrast, activity stemming from Bermuda resulted in net purchases of $335 million compared with net sales of $110 million in the last quarter of 1984. Thus, net purchases from this region spurted from $8 million in the fourth quarter of 1984 to $389 million in the first quarter of 1985.

Asian Investors

On a quarterly basis, Asian investors were net sellers of U.S. equities in 1984, with sales totaling $2.4 billion at year-end. Of this amount, activity stemming from the oil-exporting countries accounted for 84%, or $2.0 billion. In what may be a significant change in investment posture, the oil-exporting countries sold only $37 million of U.S. equities in the first quarter of 1985. As oil revenues waned, the oil exporting countries funded much development by drawing down on reserve assets, liquidating a reported $20 billion in 1984. However, based on the Saudi Arabian budget outlook for 1985-86, the government is taking a more realistic approach to project and current spending programs.[6/] First-quarter 1985 activity by the oil-exporting countries in U.S. securities--equities, Treasuries, and corporate bonds--may reflect the adoption of restrictive spending programs and, hence, a more conservative approach to investment.

While the oil-exporting countries clearly moderated their investment behavior, Hong Kong and Japanese investors dramatically increased net selling. Net sales by Hong Kong investors jumped 92% to $256 million in the first quarter from $133 million in the last quarter of 1984. U.S. equities were out of favor in 1984 with Japanese investors and Treasuries decidedly the preferred investment vehicle. This investment pattern is evident in the first quarter of 1985, with these

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5/ "East beats West--the changing pattern of Canadian growth," Economic Week, Citicorp, 3/4/85.

6/ "Saudi Arabia," Financial Times Survey, 4/22/85.

investors stepping up net sales of equities by 82% to $191 million from $105 million. For the Asia region, first quarter net sales totaled $441 million, representing a 25% drop from net sales of $593 million in the last quarter of 1984.

Foreign Activity in U.S. Corporate Bonds

The incorporation of direct Euro-issues into Treasury data pushed foreign net purchases of U.S. corporate bonds to a record $12.0 billion in 1984. Nevertheless, there were other factors, such as comparably attractive yields and capital appreciation potential, which also increased the attractiveness of U.S. corporate bonds to foreign investors, particularly in the fourth quarter. With favorable investment fundamentals in-place during most of the first quarter of 1985, foreign investors boosted net purchases by 8% to $9.9 billion from $9.2 billion.

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1984 Fourth Quarter		1985 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$14,014	$8,806	$15,338	$9,346
Belgium-Luxembourg	136	36	223	(37)
Germany	1,907	869	1,389	(187)
Switzerland	1,473	693	1,320	770
United Kingdom	9,890	7,030	11,814	8,700
Asia	1,929	229	2,076	362
Japan	718	240	1,075	203
"Other Asia"	921	(96)	649	75
Total	$17,386	$9,194	$18,646	$9,898

Source: U.S. Treasury

The large-scale buying of U.K. investors dwarfs activity from other areas. U.K. investors made net purchases of $8.7 billion of U.S. corporate bonds in the first quarter, compared with $7.0 in the last quarter of 1984. The yield differential, which usually favored U.S. corporate bonds over U.K. corporate bonds as investments in 1984, swung to favor U.K. bonds in January, given the dramatic rise in U.K. interest rates to midsummer levels.[7/] However, this spurt was short-lived and the differential favoring U.S. bonds averaged about 100 basis points in February and March. Moreover, returns on Eurodollar issues climbed from 11.05% in January to 11.73% in March.

Swiss investors boosted net purchases of corporate bonds by 11% to $770 million from $693 million. In a dramatic reversal, German investors who were avid purchasers of U.S. fixed income instruments in 1984 swung to net sellers of $187 million in the first quarter from net purchasers of $869 million in the last quarter of 1984.

Asian investors increased net purchases of U.S. corporate bonds by 58% in the first quarter to $362 million from $229 million. In part, this increase reflects the swing by investors located in the oil-exporting countries to net purchasers of $75 million of bonds from net sellers of $96 million. Purchases by Japanese investors were cut back by 15% to $203 million.

Foreign Activity in U.S. Treasury Notes & Bonds

Foreign investors enthusiastically acquired Treasuries in the second half of 1984, encouraged in part by the repeal of the 30% foreign withholding tax and specially targeted Treasury issues. Representing a near record, foreign acquisitions of Treasuries in 1984 totaled $21.4 billion. Foreign enthusiasm for Treasuries was still strong in the first two months of 1985, when net purchases of $4.6 billion were made. However, in March, large-scale net sales by central banks of $5.3 billion offset earlier purchases. Thus, first-quarter 1985 foreign activity in U.S. Treasuries resulted in net purchases of only $237 million, a far cry from the $12.6 billion acquired in the fourth quarter of 1984.

European holdings of Treasuries increased by $11.1 billion in 1984. In the first quarter of 1985, however, interest in Treasuries subsided and central bank intervention in foreign exchange markets became apparent. U.K. and German investors were the most avid European acquirers of Treasuries in 1984, with net purchases of $5.2 billion and $3.0 billion made respectively. In the first quarter, net purchases by U.K.

7/ Based on data in World Financial Markets, Morgan Guaranty Trust Company.

investors diminished to $370 million, which may have reflected in part a shift by these investors to short-term domestic government issues. Yields increased on these instruments from 9.33% at the year-end to almost 14% in February. For transactions stemming from Germany, central bank intervention may account for the bulk of net sales of $1.8 billion in the first quarter.

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1984 Fourth Quarter		1985 First Quarter	
	Net Purchases	Estimated Holdings[R]	Net Purchases	Estimated Holdings
Europe	$2,871	$47,086	$(984)	$46,102
Switzerland	(435)	1,753	636	2,389
West Germany	333	20,249	(1,787)	18,462
United Kingdom	1,703	13,742	370	14,112
Asia	3,284	48,384	1,530	49,914
Japan	3,724	19,954	1,315	21,269
"Other Asia"*	(2,467)	23,159	209	23,368
Nonmonetary Int'l & Regional Org.	4,185	10,094	(975)	9,119
All Countries	$12,636	$110,352	$237	$110,589

Source: U.S. Treasury

R = Revised

* Treasury has discontinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

Net acquisitions of Treasuries by Asian investors in the first quarter of 1985, $1.5 billion, was only about half the amount acquired in the fourth quarter of 1984. Japanese investors' preference for Treasuries in 1984, $6.1 billion, was unsurpassed. The record long-term capital outflow from Japan reached $54.4 billion in 1984, with much reportedly invested in U.S. fixed-income instruments. Japanese interest rates, which are heavily subject to government guidance, have remained at a relatively low rate for many years.[8/] Nevertheless, Japanese investors reduced net purchases to $1.3 billion in the first quarter of 1985 from $3.7 billion in the fourth quarter of 1984. In addition, further evidence of a shift in the investment strategy of the oil-exporting countries can be seen in first-quarter activity in Treasuries. These investors sold $6.3 billion of Treasuries in 1984, but were net purchasers of $209 million in the first quarter.

U.S. Activity in Foreign Stocks

A revival of U.S. interest in foreign stocks in the last six months of 1984 pushed annual activity to net purchases of $1.1 billion. As foreign markets surged in the first quarter of 1985, so too did U.S. investment in foreign equities. U.S. investors boosted net purchases to $1.9 billion from $715 million in the last quarter of 1984 and gross activity reached $10.0 billion. The renewed U.S. interest in foreign equities was prudent, as many foreign exchanges outperformed the U.S. market in the first three months of 1985.

There has been a reversal in the traditional international investment patterns in recent quarters. Foreign investors have been net sellers of U.S. equities, while U.S. investors have been net buyers of foreign stocks. The year 1983 marked increased U.S. attraction to foreign stocks. In that year, gross activity doubled to $30.1 billion and net purchases hit a record $3.8 billion. Although net purchases dropped in 1984, gross transactions remained around $30.0 billion. In the first quarter of 1985, both net purchases and gross activity inched past previous quarterly highs.

In the first quarter, net purchases of European stocks climbed 56% to $840 million from $538 million. While net purchases of U.K. stocks were increased by 14% to $372 million, acquisitions of Swiss and Netherlands' stocks rose by over 4 and 2 times, respectively. U.S. investors purchased $89 million of Swiss stocks and $146 million of stocks of Netherlands' companies. In addition, U.S. investors purchased $94 million of German stocks (not shown in Table IV) compared to about $40 million in all of 1984. U.S. investors have

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8/ "Japan's net exports of capital soar," Financial Times, 5/11/85.

helped drive the prices of Frankfurt's blue-chip shares to record highs in the past several months, while German investors, disbelieving their own boom, have stayed on the sidelines.[9/] Impressive corporate profit pictures for auto makers, banks and the chemical industry are reportedly behind the market rally.

U.S. investors, however, have adopted a cautious approach to French equities, with net purchases declining to $12 million in the first quarter from $28 million in the prior quarter. Amidst heated debate and vehement denials, it is growing clear that the Socialist French government will denationalize all or parts of some industrial groups and banks nationalized in 1982.[10/] This raises key questions of when, how, and what will be the impact on the Paris Bourse.

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984 Fourth Quarter		1985 First Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$3,506	$538	$3,956	$840
France	240	28	252	12
Netherlands	292	58	294	146
Switzerland	449	19	321	89
United Kingdom	2,013	325	2,514	372
Canada	1,147	(85)	1,589	363
Asia	2,896	252	3,785	685
Japan	2,496	142	3,253	573
Other	466	10	623	(19)
All Countries	$8,015	$715	$9,953	$1,869

Source: U.S. Treasury

9/ "American Bulls Are Running in Frankfurt", Business Week, 6/17/85.

10/ "The International Trader," Barron's, 5/6/85

U.S. investors were net sellers of $188 million of Canadian equities in 1984, as several investment fundamentals pointed to a dismal outlook. However, the Canadian stock market improved during the first quarter of 1985 along with the foreign investment climate. In a reported investment shift from the natural resource companies, foreign investors are concentrating buying power on manufacturing and industrial issues. U.S. investors were among those favoring Canadian stocks in the first quarter. Net purchases of $363 million were made, in contrast to net sales of $85 million in the fourth quarter of 1984.

U.S. fourth-quarter interest in Japanese stocks blossomed to full-fledged enthusiasm in the first quarter of 1985. Net purchases of $142 million of Japanese stocks were made in the last quarter of 1984, in contrast to net sales of $473 during the first three quarters. U.S. investors were quick to catch the rising Japanese market in the new year, with net purchases of $573 million made in the first three months. Japan's economic picture remains good, albeit with the ever-present threat of protectionist measures from countries importing Japanese products.

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Foreign Activity

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Foreign Activity in U.S. Securities

"Highlights"

1. Despite persistent downward pressure on the dollar over the second quarter, the rise of the stock market to record highs in June prompted foreign investors to reassess their investment posture toward U.S. equities. Although relatively modest compared with quarterly net purchase activity in recent years, foreign investors purchased $529 million of U.S. equities in the second quarter, the first time these investors have been net purchasers since the first quarter of 1984.

2. Foreign gross activity in U.S. equities dropped 7% in the second quarter to $35.5 billion from the first-quarter level of $38.0 billion. Nevertheless, at $73.5 billion through the first half of 1985, foreign gross activity is up by almost $10 billion, or 15%, from the comparable 1984 period.

3. The exceptional pace of foreign acquisition of U.S. corporate bonds, including Euro-issues, slackened in the second quarter. Foreign net purchases of corporate bonds dropped by 48% to $5.1 billion from $9.9 billion in the first quarter.

4. Based mainly on large net purchases of $5.4 billion by Japanese investors, foreign acquisition of U.S. Treasuries increased to $13.1 billion in the second quarter from only $201 million in the first.

5. After setting a quarterly record for net purchases of foreign stocks, $1.9 billion, in the first quarter, U.S. investors acquired only $25 million in the second, according to Treasury figures. While the pace of net acquisition may have slowed, the magnitude of the drop in net purchases seems questionable.

Introduction

Both the dollar and stock market are key factors for foreign investment in U.S. equities. In the first quarter of 1985, the volatility of the dollar and sluggish progress of the stock market kept foreign investors wary of U.S. equities. Foreign net sales totaled $1.1 billion in the first three months of 1985. Despite persistent downward pressure on the dollar over the second quarter, the rise of the stock market to record highs in June prompted foreign investors to reassess their investment posture toward U.S. equities. Although relatively modest compared with quarterly net purchase activity in recent years, foreign investors purchased $529 million of equities in the second quarter. This represents the first quarter these investors have taken a positive attitude toward U.S. equities since the first quarter of 1984.

The U.S. economic picture became increasingly clouded during the second quarter. While real GNP rose by 1.9% at an annual rate compared with 0.3% in the first quarter, forecasts for the second half of 1985 were decidedly split. The dichotomy: the mainstream view held that U.S. economic growth would accelerate substantially in the second half of 1985, pulling up interest rates, and the minority view placed U.S. growth at below 3% with the Fed obliged to lower interest rates further.[1/] Although still lagging projected worldwide growth, real growth in Europe is estimated by the OECD at 2-1/4% for 1985. The improvement in many European economies, with brightening profit pictures for varying industries, has been reflected in the progress of many foreign stock exchanges during the first half of the year. Nevertheless, a slowdown of U.S. expansion raises questions about the strength and sustainability of worldwide growth, given the stimulus exports to the U.S. has provided to many countries.

After a minor setback in April, the U.S. stock market rose to record highs in June. The DJI Average rose by over 5%, while the NYSE and S&P 500 indices increased by over 6%. Given the tenuous position of the dollar, foreign investors were probably hoping June would mark the beginning of a long-term rally.

Late in the first quarter, the dollar started to weaken. The pace of the dollar's decline accelerated in the second quarter, with all major currencies gaining against the dollar by the end of June. The sharpest gain vis-a-vis the dollar was scored by the British pound, 6.9%, while the Swiss franc came in second with a rise of 3.7%. The strides of other currencies

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1/ Foreign Exchange Market Trends, Irving Trust, 8/8/85

against the dollar ranged from 2.7% for the French franc to 0.6% for the Canadian dollar. The dollar's fall from end-June to end-July was particularly steep, as the French franc jumped 10.8% against the dollar and the mark, 8.5%.

Foreign Activity in U.S. Equities

Gross Activity

Foreign gross activity in U.S. equities dropped 7% in the second quarter to $35.5 billion from the first-quarter level of $38.0 billion. European and Asian investors cut activity by 12% and 17%, respectively, while Canadian investors boosted transactions by 5%. Activity by Latin American and Caribbean investors escalated by a significant 19% to $6.4 billion in the second quarter. At $73.5 billion through the first half of 1985, foreign gross activity in U.S. equities is up by almost $10 billion, or 15%, from the comparable period in 1984.

Net Purchases

Representing the first time since the first quarter of 1984, foreign investors were net purchasers of U.S. equities in the second quarter of 1985. However, not all foreign investors had renewed confidence in the U.S. stock market and the quarterly data show unusual shifts in investment positions. European investors remained net sellers of equities, $369 million, albeit at a substantially reduced pace from the first-quarter level of $1.3 billion. The sustained interest of Canadian investors in U.S. equities waned and net sales of $20 million were made. While net purchases by Latin American and Caribbean investors were increased a significant 40% to $546 million, the most notable shift in investment came from the Asian region. In the second quarter, Asian investors swung to net purchases of $409 million from net sellers of $441 million in the first quarter.

European Investors

European investors dramatically moderated net selling of U.S. equities in the second quarter. Net sales of $369 million were made, compared with $1.3 billion in the first quarter. In general, European investors either substantially decreased net sales or swung to net purchasers of U.S. equities. U.K. investors were the exception, boosting net sales by over 50% to $356 million. Net sales by Dutch and Swiss investors underwent considerable reduction, to $117 million and $91 million, respectively. French and German investors reversed their net selling posture, purchasing $67 million and $66 million of U.S. equities, respectively.

U.K. investors were the only major European investors to step up net sales of U.S. equities in the second quarter. Net sales were increased by 51% to $356 million from $235 million

in the first quarter. Measured in terms of sterling, the U.K. stock market was basically lackluster in the first six months of 1985, underperforming the U.S. market. However, the boost in U.K. interest rates early in the year that precipitated the recovery of sterling vis-a-vis the dollar also precipitated an increase in returns on certain domestic fixed income instruments.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1985 First Quarter		1985 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$20,632	$(1,344)	$18,061	$(369)
Belgium-Luxembourg	1,031	20	859	60
France	1,753	(73)	1,343	67
Germany	1,732	(356)	1,144	66
Netherlands	931	(279)	965	(117)
Switzerland	5,404	(414)	4,866	(91)
United Kingdom	9,222	(235)	8,286	(356)
Canada	4,735	213	4,971	(20)
Latin America & Caribbean	5,397	389	6,417	546
Bermuda	1,875	335	2,679	223
Netherlands Antilles	1,919	11	1,986	210
Asia	6,422	(441)	5,355	409
Hong Kong	1,048	(256)	661	79
Japan	1,944	(191)	1,355	191
"Other Asia"*	3,021	(37)	2,776	43
Total All Countries	$37,961	$(1,137)	$35,465	$529

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

Swiss investors reduced net selling of U.S. equities to $91 million in the second quarter, after making net sales of over $400 million in each of the two previous quarters. The Swiss economic expansion has been relatively strong, with a growth prospect of over 3% expected again in 1985. The stable growth experienced by the economy has been reflected in its capital markets. The most striking development has been in the equity market, where large-scale buying by domestic and foreign investors was breaking share volume records daily and propelling turnover of at least one-third higher than the first half of 1984.[2/] The heated equities market has also translated to increased demand in the fixed income sector, giving rise to the popularity of equity-linked convertible and warrant bonds. Swiss funds are finding their way back to domestic investments.

Several considerations could have prompted the second-quarter reversal of investment posture toward U.S. equities by French investors. These investors purchased $67 million of equities, in contrast to net sales of $73 million in the first quarter of 1985. A combination of unusual circumstances sent the French stock market on a steady uphill path over the past three years and tripled the size of the bond market. The impetus for much of the expansion came from Socialist government policies aimed at making domestic investment more attractive. However, market progress began to erode in May, as political concerns built and the dollar dropped. On the political side: parliamentary elections are in the offing and it looks as if a right-wing government will be coupled with the current Socialist President.[3/] Moreover, foreign investors are reportedly retreating and cashing in their exchange rate gain on the dollar. Second-quarter Treasury figures, however, show U.S. investors still purchasing a moderate amount of French shares.

In a dramatic swing, German investors purchased $66 million of U.S. equities in the second quarter, reversing position from net sellers of $356 million in the first quarter. Given a booming domestic stock market which has attracted attention from U.S. investors among other foreigners, it seems somewhat unusual that German investors would become net purchasers of U.S. equities. However, the strengthening of the mark and the possibility of a U.S. market rally may have prompted German investors to become net purchasers.

2/ "Healthy Swiss climate promotes growth," Financial Times, 7/9/85.

3/ "The International Trader," Barron's, 8/5/85.

Canadian Investors

The long-sustained interest of Canadian investors in U.S. equities disappeared in the second quarter. These investors made net sales of $20 million, in contrast to net purchases of $213 million in the first quarter. However, Canadian investors may have been realizing gains in June, as Treasury data show that they were net purchasers in both April and May.

Asian Investors

Activity stemming from the Asian region represents the most unusual shift in investment patterns in the second quarter. Net purchases of $409 million were made, with all major countries contributing to the position. Japanese investors, who have not been net purchasers of U.S. equities since the second quarter of 1984, acquired $191 million in the second quarter of 1985. Given an estimate of almost $40 billion in Japanese capital outflow in the first seven months of 1985, it is not surprising that some of the outflow was invested in U.S. equities. Nevertheless, the Japanese preferred investment vehicle remains U.S. Treasuries. Investors from both Hong Kong and the oil-exporting countries also took a positive and atypical position on investment in U.S. equities, purchasing $79 million and $43 million, respectively.

Foreign Activity in U.S. Corporate Bonds

The exceptional pace of foreign acquisition of U.S. corporate bonds, including Euro-issues, slackened in the second quarter of 1985. Foreign net purchases averaged $9.5 billion in the last quarter of 1984 and the first quarter of 1985. However, U.K. investors were responsible for the bulk of net acquisitions and their diminished interest precipitated much of the second-quarter falloff. Net purchases of U.S. corporate bonds by foreign investors dropped 48% in the second quarter to $5.1 billion from $9.9 billion in the first quarter.

With decreasing U.S. returns came a decreasing of the large-scale activity of U.K. investors in U.S. corporate bonds. U.K. investors reduced net purchases of corporate bonds by 46% to $4.7 billion in the second quarter from $8.7 billion in the first. Nevertheless, U.K. investors still account for the lion's share, about 90%, of net acquisitions of corporate bonds. Yields on U.S. corporate bonds maintained a favorable differential of almost 100 basis points over U.K. yields during much of the first quarter.[4/] This gap, however, narrowed

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4/ Based on data in World Financial Markets, Morgan Guaranty Trust Company

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1985 First Quarter		1985 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$15,338	$9,346	$11,948	$5,208
Belgium-Luxembourg	223	(37)	382	217
Germany	1,389	(187)	1,801	156
Switzerland	1,320	770	854	217
United Kingdom	11,814	8,700	8,319	4,663
Asia	2,076	362	3,305	(192)
Japan	1,075	203	1,298	646
"Other Asia"	649	75	1,664	(951)
Total	$18,646	$9,898	$17,335	$5,125

Source: U.S. Treasury

sharply in April and during the next two months U.K. issues were favored by an average of about 33 basis points. In addition, returns on Eurodollar issues fell 124 basis points during the second quarter.

Asian investors swung from net purchasers of $362 million of U.S. corporate bonds in the first quarter to net sellers of $192 million in the second. Japanese investors increased net purchases by three times to $646 million from $203 million. These investors showed exceptional interest in U.S. Treasuries in the second quarter and this interest carried over to corporate fixed-income instruments. On the other hand, the oil-exporting countries, which purchased a modest $75 million of corporate bonds in the first quarter, swung to net sellers of $951 million in the second.

Foreign Activity in U.S. Treasury Notes & Bonds

Foreign enthusiasm for U.S. Treasury notes and bonds waned considerably in the first quarter of 1985, based in part on large-scale net sales by central banks. In the second quarter, however, Japanese investors were avid purchasers of Treasuries, pushing foreign acquisitions to a quarterly record of $13.1 billion. In part, the level of acquisitions also reflects foreign interest in the third foreign-targeted issue of the Treasury. Estimated foreign holdings of Treasuries jumped to $123.7 billion at the end of the second quarter.

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1985 First Quarter		1985 Second Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$(984)	$46,102	$3,657	$49,759
Switzerland	636	2,389	190	2,579
West Germany	(1,787)	18,462	1,555	20,017
United Kingdom	370	14,112	(658)	13,454
Asia	1,531	49,914	7,029	56,943
Japan	1,315	21,269	5,437	26,706
"Other Asia"*	209	23,368	597	23,965
Nonmonetary Int'l & Regional Org.	(975)	9,119	803	9,922
All Countries	$201	$110,553	$13,106	$123,659

Source: U.S. Treasury

* Treasury has discontinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

European net purchases of Treasuries spurted to $3.7 billion, compared to net sales of $984 million in the first quarter. The swing by German investors from net sellers of $1.8 billion of Treasuries in the first quarter to net purchases of $1.6 billion in the second is mainly responsible for the shift. German investors have shown a strong preference for Treasury issues in the past, given the attractive yields on U.S. issues relative to domestic government issues. U.K. investors, on the other hand, swung to net sellers of $658 million of Treasuries from net purchasers of $370 million in the first quarter. While the differential favoring U.S. government issues narrowed to only 17 basis points over the quarter, returns available on other U.K. fixed income investments were at attractive levels and, in many cases, more generous than those on U.S. counterparts. Also contributing to net activity from Europe were net purchases of almost $1 billion each stemming from Norway and Sweden (not shown in Table III).

Given the dramatic slack in the pace of overall net foreign acquisitions of Treasuries in the first quarter, some observers concluded that foreigners, particularly Japanese investors, were losing their interest in U.S. markets. Second quarter data should quiet these fears. Japanese investors purchased $5.4 billion of Treasuries. Although Japanese investors are becoming more interested in securities denominated in currencies other than the dollar, because Japanese institutions have such large amounts of funds available, they will continue to make new investments in dollar-denominated securities.[5/] The oil-exporting countries showed increased attraction to Treasuries, purchasing $597 million in the second quarter compared with $209 million in the first quarter.

U.S. Investor Activity in Foreign Stocks

After acquiring a record $1.9 billion of foreign stocks in the first quarter of 1985, U.S. interest in overseas companies plummeted to only $25 million according to Treasury data. Gross activity remained at an accelerated level, slipping only 3% to $9.6 billion in the second quarter. A sample check of monthly underlying flow reports by broker/dealers is consistent with a slowing in the pace of U.S. net acquisition of foreign stocks. However, conversations with various broker/dealers confirm that U.S. investors were still very much interested in foreign stocks. The basic fundamentals for U.S. overseas investment were in-place, given the impressive progress of many foreign stock markets in the first half of the year and the strengthening of most major currencies against the dollar in the second quarter. We, therefore, question the magnitude of the decline in U.S. net purchases of foreign stocks as shown in the Treasury data.

5/ "Foreign Prop for U.S. Issues," New York Times, 7/29/85.

Treasury data are an indication of the trend in investment flows and not necessarily of the exact magnitude of those flows. As more U.S. institutions commit funds directly to foreign money managers, there is a possibility that some funds are not captured by the existing reporting mechanism. This would be one explanation for the decline in reported U.S. interest in foreign equities. Nevertheless, Treasury is the only source of information on capital flows and the following is based on Treasury data.

U.S. investors reduced net purchases of European stocks 80% to $169 million in the second quarter from $840 million in the first quarter. Net sales of $77 million and $69 million of Dutch and Swiss stocks, respectively, were made, while net purchases of U.K. stocks were cutback to $79 million. U.S. investors increased net purchases of French stock by 33% to $18 million from $12 million. Paris brokers estimate that between 15% to 20% of all daily transactions now involve foreign investors, with foreigners gambling on the stability of the franc in recent months and the centrist shift of the Socialist Government.6/

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1985 First Quarter		1985 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$3,956	$840	$4,739	$169
France	252	12	230	18
Netherlands	294	146	351	(77)
Switzerland	321	89	331	(69)
United Kingdom	2,514	372	3,015	79
Canada	1,589	363	1,335	147
Asia	3,785	685	2,802	(300)
Japan	3,253	573	2,333	(371)
Other	623	(19)	763	9
All Countries	$9,953	$1,869	$9,639	$25

Source: U.S. Treasury

6/ "Bourse get pre-election jitters," Financial Times, 6/29/85.

U.S. investors maintained a steady interest in German shares, escalating net purchases by 28% to $120 million in the second quarter from $94 million in the first (not shown in Table IV). The German stock market has been among the top performers in the first half of 1985. In addition, the German government has been taking steps toward deregulating and liberalizing the financial markets, in part to enhance the attraction of the mark as an investment currency. U.S. investors evidently have found the trend promising. Also accounting for the positive position in European stocks were purchases of $93 million of Italian stocks. In terms of the lira, the Italian market has risen 44% in the first six months of 1985, the second best performing international market.7/

While U.S. investors decreased net purchases of Canadian stocks by 60% to $147 million, they dramatically changed their attitude toward Japanese stocks. After making purchases of $573 million in the first quarter, U.S. investors sold $371 million of Japanese stocks in the second. The Japanese stock market, although attaining record highs, has become increasingly erratic. U.S. investors may be pausing for a clearer direction on market trends. Reportedly, market sentiment has shifted away from export-oriented issues, which are typically over represented in overseas portfolio, to domestic sector stocks, but foreign investors have failed to follow suit.8/

Carolyn Hildebrandt
Assistant Vice President

7/ Based on Capital International's market indexes, Capital International Perspective of Geneva.

8/ "The Stock Market Turns Inwards", Euromoney, 9/85.